

# FIRST PRINCIPLES OF VALUE

APPRAISAL INSTITUTE OF CANADA

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## FIRST PRINCIPLES OF VALUE

There are many aspects of real property consulting. Without suggesting any limitations, this concept may include valuation, use strategies, feasibility studies, litigation strategies, academic pursuits, and forecasting and strategic implementations. Even these examples can be expanded and refined. However, a common thread in each real property discipline is the need to understand the interrelationships between forces of economics, law and the marketplace on real property. The reliance on various Principles allows for a focused and disciplined approach to the requisite analyses and interaction between the various tangents that real estate consultants may pursue. Furthermore, a common understanding will enhance communication between consultants and their clients.

In order to achieve use of the CRA or AACI designation, the candidate must have experience and be proficient in the following First Principles of property value. Candidates employed in any of the real estate related disciplines listed must have experience in application and principles, which currently include the following:

### PROBLEM IDENTIFICATION

The initial step in any valuation or consulting assignment is to understand the objective of the assignment. If the assignment is to opine on "market value", it is imperative to understand what is being valued and when is the value opinion to be effective. If the assignment is for a reason other than "market value" or extends beyond the issue of "market value" it remains imperative to understand the specifics of the issue being addressed in the analyses, opinions or initiative.

### PROPERTY CONTENT/PROPERTY RIGHTS

#### Property Content

In order to begin any assignment, the subject property(s) must be identified under four basic headings:

- (i) physical understanding, to include size, shape and topography of land; size, shape and utility of improvements (as this is only the initial step, further detail will be learned during the course of the investigations);
- (ii) legal understanding, to include the type of ownership (fee simple, leased fee, leasehold condominium, life estate etc. )
- (iii) financial understanding, to include debt and equity elements (the exact measurement will not be understood until completion of a valuation analysis if this is the focus of the assignment, but the existence of these characteristics will help direct the requisite research or facilitate a consulting assignment), and;
- (iv) location understanding, to understand the socio-economic and geographic context of the assignment.

Regardless of the type of assignment/project the real estate consultant is engaged in, this fundamental knowledge is critical. For example, it may be that the issue of debt is of no consequence in a particular decision, but without the knowledge of the impact of debt on the property markets even a decision about its lack of importance in a particular assignment is unachievable.

#### Property Rights

A formal definition can be found in basic real estate appraisal textbooks. An information discussion is provided herein.



Real property can only be valued, manipulated or otherwise used or discussed based on two legal criteria. Firstly, the consultant must identify what use permissions are available. Secondly, the consultant must identify what uses are not permissible, or the limitations (i.e. extent) on the permissible uses.

It is important to recognize that influences on property rights emanate from a variety of laws (federal, provincial/territorial, municipal, criminal, civil) and also include private agreements. Some are direct (i.e. zoning) and some indirect (i.e. capital gains taxation). The consultant must understand the property rights on the subject(s) and marketplace in general in order to conduct meaningful analyses.

It is incumbent on the valuer/consultant to understand what definition of "value" is appropriate to any principles of value assignments, and clearly identify the definition in any conclusions.

The traditional real estate valuation definition of fair market value (typically relied upon in appraisals completed for financing, etc.) may note the appropriate definition for an expropriation, assessment, site selection or other applications of our knowledge of principles of value. The definition relied upon provides a definable benchmark against which decisions affecting the property can be measured and presented to a third party within an appropriate context.

### **FUNCTION/PURPOSE**

The Purpose of the assignment is imbedded in the discussion of Problem Identification. To reiterate, it is imperative for the valuer/consultant to understand the object of the assignment.

The Function of the assignment may be to inform an educated client, assist a judicial body in a determination, or give guidance to a lender (with many other possibilities additional to this list). The Function of the assignment will also help guide the valuer/consulting in suggesting the type of report to be prepared, estimate a reasonable fee and be assured of a reasonable time to complete the necessary tasks.

### **HIGHEST & BEST USE**

The principle enjoys a specific definition in accordance with the Appraisal Institute of Canada, as follows:

"that use which, at the time of appraisal, is most likely to produce the greatest net return, in money or amenities, over a given period of time"

A more complete formal definition is available in various textbooks.

A practical review of the concept necessitates an understanding of (i) legal permissions and limitations (see Property Rights), the permissions that are available to real property, (ii) information about what permissions may practicably be available to real property, and (iii) what uses are not and would likely remain unavailable to real property. Without this knowledge the consultant /user cannot assess the various uses achievable.

### **LAND USE REGULATIONS**

Land use regulations are considered a subset of Property Rights and Highest and Best Use. Land use regulations provide (i) the permissions that are available to real property (ii) information about what permissions may practicably be available to real property and (iii) what uses are not and would likely remain unavailable to real property. Without this knowledge, the consultant/user cannot assess the various uses achievable.



## **ECONOMIC VARIABLES**

To understand what is meant by Economic Variables, it is first necessary to understand what economics means. In essence, economics is the study of the allocation of scarce resources. Land and market inputs all have limitations. Wasn't it Will Rogers who said of land "They ain't making any more of it"?

Economic Variables is an all-encompassing term that catches tangible and intangible inputs to the real property market. Tangible examples might be the supply of land in an identifiable area, or the availability of labour. Intangible examples might be the cost of money (interest) or inflation rates.

## **LEGAL ISSUES**

The concept is broad in its scope but inescapable in all valuation/consulting assignments. Law affects all real matters. It may be limited to Property Rights or Land Use Regulations matters. It may be the focus of the project, such as litigation strategy assignments. It may be direct such as having knowledge of an Expropriation Act, or indirect such as taxation policies or in recognizing the contingent liability when an opinion is delivered.

Law may be Municipal, Provincial/Territorial, Federal or International. It is not necessary for the consultant to be an expert in all aspects of law. But it is incumbent on the consultant to be aware of changes in law and have a basic knowledge of those aspects of law having a direct bearing on a particular assignment (i.e. Expropriation/Assessment Acts). Furthermore, each consultant should establish relationships with lawyers expert in a variety of aspects of law, so that they can be made aware of changes that could impact on real estate consulting matters.

## **RESEARCH**

Valuation and consulting assignments are typically a mixture of fact and opinion. Presumably the latter is predicated on the interpretation of the former. Without appropriate facts, opinions are without foundation.

Research is typically divided between (i) gathering knowledge of the subject(s) and (ii) appropriate market evidence.

Without adequate knowledge of the subject the consultant is unable to offer any constructive comment on the real property. For example, a site may be 43,560 square feet (one acre). This could mean a site with dimensions 66 feet x 660 feet, perhaps inappropriate for a residential home, but ideal for a roadway.

Alternatively, the site could be about 208 feet square, with the opposite appropriate uses. Thus, adequate knowledge of the subject property, coupled with knowledge of the problem is necessary.

The real estate consultant cannot operate in isolation of the marketplace. Once the inputs necessary to the solution of a problem are identified they can be reached. The accuracy of the evidence is of vital importance. Depending once again on the Problem, the research surrounding the market evidence may be as detailed as the research conducted on the subject property. Local standards and purpose of the assignment may dictate otherwise. But in all circumstances there must be at least a reasonable amount of research in order for the consultant to rely reasonably on such data.

The information confirmation process is often referred to as due diligence.

